State of Florida

Public Service Commission

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TALLAHASSEE, FLORIDA 32399-0850

-M-E-M-O-R-A-N-D-U-M-

DATE: December 19, 2017

TO: All Interested Persons; Office of Public Counsel; All Water and Wastewater

FROM: Adria Harper, Senior Attorney, Office of the General Counsel AEH

RE: Undocketed – Comments re: December 14, 2017, Rulemaking Workshop for Rule 25-30.4575, F.A.C., Operating Ratio Methodology

Staff requests that the attached comments from U.S. Water Services Corporation for Rule 25-30.4575, Operating Ratio Methodology, be placed in the undocketed file.

Thank you.

AEH

December 19, 2017

Ms. Adria Harper
Office of General Counsel
Florida Public Service Commission
2540 Shumard Oak Blvd.
Tallahassee, FL 32399-0850

Re: Proposed Adoption of Rule 25-30.4575, Florida Administrative Code – Operating Ratio Methodology

Dear Ms. Harper,

In response to the Staff Workshop held on December 14, 2017 for the above mentioned proposed rule adoption and Notice of Development Rulemaking related to codifying Commission past practice of approving an Operating Ratio Methodology, I offer the following comments.

I am currently the Vice President of Investor Owned Utilities for the following utilities regulated by the Florida Public Service Commission:

Black Bear Waterworks, Inc.
Brendenwood Waterworks, Inc.
Brevard Waterworks, Inc.
Country Walk Utilities, Inc.
Harbor Waterworks, Inc.
HC Waterworks, Inc.
Jumper Creek Utility Company
Lake Idlewild Utility Company
Lakeside Waterworks, Inc.
LP Waterworks, Inc.
Merritt Island Utility Company
North Charlotte Waterworks, Inc.
Pine Harbour Waterworks, Inc.
Raintree Waterworks, Inc.
Seminole Waterworks, Inc.
Sunny Hills Utility Company
The Woods Utility Company

General Comments on the Operating Margin Methodology

As discussed at the workshop, the FPSC first utilized the operating ratio methodology in 1996 by Order No. PSC-96-0357-FOF-WU, issued March 13, 1996 (Lake Osborne Order). As stated in the Lake Osborne Order, the operating ratio method recognizes that a major issue for small utilities is cash flow, therefore, the operating ratio method focuses more on cash flow than investment. (Page 4). The Office of Public Counsel (OPC) stated its belief that the operating ratio is analogous to the newly adopted Rule No. 25-30.0444, F.A.C. – Utility Reserve Fund. This is not the case. As stated in Rule 25-30.0444, F.A.C., the Utility Reserve Fund is a mechanism to allow for advanced recovery of infrastructure repair or replacement projects of existing distribution and collection infrastructure that is nearing the end of its useful life or is detrimental to water quality or reliability of service.

As previously stated in the Lake Osborne Order, the Commission found that the issues facing Lake Osborne *and others in similar circumstances* are those of cash flow and, *equally as important*, inadequate margin to allow for capital replacement and inability to sustain significant **unanticipated expenses** such as line breaks, pump failures, etc. These are unanticipated and unexpected increases or expenses not foreseen to the utilities. The Commission continued by stating that these needs continue in the absence of a return component due to lack of rate base. (Page 5) I agree with the Commission's assessment and conclusions. There is no correlation of the operating ratio methodology and the Utility Reserve Fund. These two distinctly different ratemaking methodologies address two non-related items.

The OPC also expressed its concern regarding the customer's contributions-in-aid-of-construction (CIAC). The Lake Osborne Order addressed these concerns on page 4 of the order and no further comment is required since this was previously addressed by the Commission.

The Commission also addressed the "perception or concern" that the operating ratio method would "unjustly enrich" the utility owner through a perceived excessive rate of return. I agree with the Commission's assessment of this impact of operating ratio method on rate of return also articulated on page 4 of the Lake Osborne Order and no further comment is needed.

Recently, the Commission approved an operating ratio in Order No. PSC-15-0013-PAA-WS, issued January 2, 2015 (Lakeside Order). It should be noted that the OPC was a party to a Settlement Agreement between the OPC, Lakeside and the Homeowners Association. The Commission approved the Joint Motion Requesting Approval of the Settlement Agreement in this Lakeside Order. On page 23 of the Lakeside Order, the Commission stated that if the return on rate base method were applied, Lakeside could be left with *insufficient funds to cover* ***operating expenses.*** Thus the Commission stated that the operating margin should provide adequate revenue to protect against potential variability in revenues and **expenses**. The Commission concluded that if the utility's operating expenses increase and revenues decreases, the utility would not have the funds for day-to-day operations. I agree that the operating ratio works as a surrogate of a working capital allowance for utilities.

Where working capital is defined as:

> The investor supplied funds necessary to meet operating expenses or going concern requirements of the business. There is normally a time lag between the point when service is rendered and the related operating costs are incurred and the point when revenues to recover such costs are received. The working capital allowance may include balance sheet items not previously included in the rate base or cost of capital calculations. These operating funds to bridge the lag are usually supplied by the investor and become a fixed commitment to the utility.

The Commission also stated that the operating ratio methodology rests on the contention that the principal risk to the utility resides in operating cost rather than in capital cost of the plant. Continuing on page 23 of the Lakeside Order, the Commission stated that the fair return on a small rate base may not adequately compensate a utility owner for incurring the risk associated with covering the much larger operating cost. The Commission concluded that the margins under traditional rate base methodology do not provide a sufficient financial "cushion," and do not adequately compensate the utility owner for that risk. I agree with the Commission's findings and conclusion in the Lakeside Order. Again, the OPC was a party in this SARC docket and agreed to the use of the operating margin in its Settlement Agreement.

It should be noted that private investors of regulated utilities expect an opportunity to earn a return on their investment. This return on equity is typically a component of the overall rate of return determined by the Commission in rate cases and are typically applied to the utility's net rate base. In the instances of little to no rate base, there is **no opportunity** for a return on the shareholder's investment in these utilities. Typically, these small utilities often have difficulties in obtaining debt in the open market due to the inability to repay these loans and interest. This is also caused by low to little depreciation to repay the principle as well as no rate of return to pay the interest. Thus these utilities must rely on the owners (shareholders) in order to both meet day to day operational costs, as well as make utility capital investment to plant in service in order to maintain safe and reliable service to the customers. Without any possible return on the owners' investment (equity) it often becomes difficult to attract or maintain additional equity contributions for these small utilities.

As stated in the Lake Osborne Order, the Commission found that a utility, like any other business, needs an adequate margin of revenues over expenses in order to remain viable. (Page 5) The Commission also previously determined that the purpose of the return (margin) is to provide an appropriate margin to pay any debt interest and to cover revenue and expense variations (Lake Osborne Order, page 7). I agree with these findings.

It is imperative that the Operating Margin Methodology be preserved and maintained by the Commission for water and wastewater utilities. Many of the utilities that I manage have little to no rate base through no fault of the acquiring utility and are faced with financial difficulties meeting day-to-day operations. Just as many of these utilities were financially non-viable, distressed utilities that were acquired in order to turn them around and provide safe and reliable service to the customers. Without the operating margin, several of these utilities would either not have been acquired and/or would remain financially non-viable. I urge the Commission to maintain this regulatory certainty in order to encourage the acquisition of distressed utilities by entities with greater technical and financial ability and utility experience.

Specific Comments on the Proposed Rule:

I agree that the percentage of margin should be evaluated to determine whether the previous ten percent (10%) is adequate. This 10% amount was established in 1996 or more than 20 years ago. In the Lake Osborne Order, the Commission stated that it may be appropriate to apply a margin greater than 10% in the case of a fully depreciated system where there would be an expectation of greater than average volatility in operation and maintenance costs. The Commission also set a cap operating margin of $10,000. Again this was more than 20 years ago and should be further evaluated. The Commission stated that the important question is not what the return percentage should be, but what level of operating margin will allow the utility to provide safe and reliable service and remain a viable entity. (Page 8) As stated at the workshop, the Lake Osborne Order states that many states actually had higher margin percentages in 1996.

Thank you for your consideration, and if you have any questions, please do not hesitate to contact me at (727) 848-8292, ext. 245, or via e-mail at trendell@uswatercorp.net.

Sincerely,

Troy Rendell

Troy Rendell
Vice President
Investor Owned Utilities